INSTITUT C.D. HOWE INSTITUTE

COMMENTARY
NO. 413

What Now? Addressing the Burden of Canada's Slow-Growth Recovery

Canadian policymakers should accept the continuation of Canada's slow-growth recovery for the next few years. In the meantime, they can address the undesirable consequences of slow growth by enhancing income support for the unemployed, increasing the mobility of workers and improving incentives for labour-market training.

Christopher Ragan

About The Author

Christopher Ragan is an Associate Professor of Economics at McGill University and Research Fellow at the C.D. Howe Institute.

The Institute's Commitment to Quality

C.D. Howe Institute publications undergo rigorous external review by academics and independent experts drawn from the public and private sectors.

The Institute's peer review process ensures the quality, integrity and objectivity of its policy research. The Institute will not publish any study that, in its view, fails to meet the standards of the review process. The Institute requires that its authors publicly disclose any actual or potential conflicts of interest of which they are aware.

In its mission to educate and foster debate on essential public policy issues, the C.D. Howe Institute provides nonpartisan policy advice to interested parties on a non-exclusive basis. The Institute will not endorse any political party, elected official, candidate for elected office, or interest group.

As a registered Canadian charity, the C.D. Howe Institute as a matter of course accepts donations from individuals, private and public organizations, charitable foundations and others, by way of general and project support. The Institute will not accept any donation that stipulates a predetermined result or policy stance or otherwise inhibits its independence, or that of its staff and authors, in pursuing scholarly activities or disseminating research results.

Commentary No. 413
July 2014
Monetary Policy; Fiscal Policy

$12.00
ISBN 978-0-88806-935-1
ISSN 0824-8001 (print);
ISSN 1703-0765 (online)

Finn Poschmann
Vice-President, Policy Analysis

THE STUDY IN BRIEF

The Canadian economy faces serious short-term macroeconomic challenges, the most important of which is addressing the burden of our slow-growth recovery. The sources and consequences of this slow growth are the focus of this *Commentary*.

Canadian monetary policy has little ability to further stimulate Canadian growth. Given the large amount of uncertainty now faced by Canadian firms, further reductions in the policy interest rate are unlikely to be effective in stimulating aggregate demand. In addition, the ongoing problems associated with very low interest rates cannot be ignored and may soon present the Bank of Canada with a compelling case for rate increases.

Canadian fiscal authorities have more room to manoeuvre than their counterparts in many other developed countries. Yet there remain solid arguments for budgets to be brought back to balance in the next few years. One is that discretionary fiscal policy is an ineffective pro-growth policy when the economy is not experiencing a sudden collapse of aggregate demand. Another is the longer-term budgetary challenges that Canadian governments will face over the next few decades as a result of population aging.

Neither fiscal nor monetary policy is therefore likely to stimulate Canada's economic growth over the next few years. This lack of stimulus from traditional macroeconomic policy suggests that any pick-up in Canadian growth will rely on a recovery of private demand.

Given the lingering uncertainty and the continued slow pace of the global economic recovery, however, a significant rebound in Canadian private demand is unlikely in the near future. High household debt suggests that consumption is an improbable source of near-term growth. An investment revival will require a return of corporate confidence, while a rally in Canadian exports will depend on a strong and sustained foreign recovery.

A central conclusion of this *Commentary* is therefore that Canadian policymakers should accept the continuation of Canada's slow-growth recovery for the next few years. Slow growth has undesirable consequences, however, including longer unemployment spells, more part-time employment, and a greater incidence of long-term unemployment. Policymakers should focus on addressing the associated burden by enhancing income support for the unemployed, increasing the mobility of workers and improving incentives for labour-market training.

C.D. Howe Institute Commentary© is a periodic analysis of, and commentary on, current public policy issues. Michael Benedict and James Fleming edited the manuscript; Yang Zhao prepared it for publication. As with all Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors. Quotation with appropriate credit is permissible.

To order this publication please contact: the C.D. Howe Institute, 67 Yonge St., Suite 300, Toronto, Ontario M5E 1J8. The full text of this publication is also available on the Institute's website at www.cdhowe.org.

The global financial crisis in 2008 led to a major worldwide recession, with the most dramatic impact occurring in countries whose banks and financial markets were most exposed to securities backed by US residential mortgages. Though Canada was not at the epicentre of these financial developments, highly globalized financial markets and trade linkages meant that Canada could avoid neither the shocks to credit markets nor the effects on output and employment that soon followed.

BIG CRISIS, BIG RESPONSE

Together with the other G-20 countries, Canada responded with significant policy measures designed to encourage the smooth operation of financial markets and to support aggregate demand.

Monetary policy was naturally the first focus, with most central banks reducing their policy rates early in 2008 and then much more aggressively after the fall of Lehman Brothers that September. Beginning in 2009, some central banks began to take more aggressive actions involving enormous expansions of their balance sheets (Kozicki et al., 2011). Governments also designed specific and, typically, temporary policies directed at improving the operation of financial markets. It was at this time that the notion of the "shadow banking system" appeared, a term conveying the idea that much activity in financial markets is well outside the limelight normally accorded to commercial banks.

Fiscal stimulus was also part of the policy response, and Canada participated in the G20 countries' attempt to coordinate similarly sized fiscal packages in which direct government spending on infrastructure projects played a leading role. The nature of these fiscal measures reflected existing thinking that short-run multiplier effects would be larger with temporary increases in spending than with temporary tax reductions. The coordination across countries was pursued partly as a means of reducing the impact on exchange rates and the leakage to imports, thereby increasing the overall efficacy of the policy (Freedman et al. 2009; Spilimbergo et al. 2009).

In Canada's case, the adoption of Keynesian federal budgets in 2009 and 2010 represented a reversal of Ottawa's previously stated position that budget deficits would be unnecessary for economic recovery. At the time, the conventional wisdom held that monetary policy remained by far the most effective and timely tool for macro stabilization during normal times. But the global financial crisis was soon recognized to be sufficiently abnormal as to require a wider set of policy tools. With

I thank David Meredith for valued research assistance. I also received helpful comments from Jean-Pierre Aubry, Colin Busby, Mel Cappe, John Crow, David Dodge, David Gray, Glen Hodgson, Paul Jenkins, Thorsten Koeppl, David Laidler, Angelo Melino, Peter Nicholson, Bill Robson, Daniel Schwanen, Jim Stanford, Armine Yalnizyan and several anonymous referees. Any errors are mine.

the sudden and large collapse in confidence that followed the dramatic events in the United States and Europe, it was likely that monetary policy alone would be insufficient to restore aggregate demand. Other approaches were needed to repair the functioning of financial markets, and direct fiscal stimulus was needed to support aggregate demand (Canada 2009; Ragan 2010).

Finally, the G20 leaders also agreed to avoid the imposition of new protectionist measures on trade or foreign investment, an attempt to resist the protectionist instinct that often accompanies periods of economic decline (G20 2008). Though subsequent months saw the introduction of limited protectionist measures in some countries, these occurrences were relatively rare and possibly kept in check through an alert media.

Looking back at 2008 and 2009, it is difficult to avoid the conclusion that the policy responses to the global financial crisis, in Canada as well as among its G20 partners, were well designed and effectively implemented. There are naturally disagreements about important details of the various policy measures, but the aggressive actions taken by central banks and national treasuries – to support financial institutions, improve the functioning of financial markets, stimulate aggregate demand and avoid an increase in protectionism – suggest that decisionmakers had learned from the major policy mistakes incurred during the Great Depression (Temin 1989). This is a significant achievement.

By international comparison, Canada has fared well over the past six years. Though Canada experienced sharp declines in real GDP and employment through early 2009, our recovery has been more pronounced than in most other countries. Both output and employment are now well above their pre-recession peaks.

The Canadian economy nonetheless continues to face serious macroeconomic challenges in the wake of the global financial crisis, not the least of which is an unusually tepid, slow-growth recovery. The causes and consequences of this slow growth are the focus of this *Commentary*.

It establishes the following main arguments:

- Canadian monetary policy has little ability to further stimulate Canadian growth. Reductions in the policy interest rate are unlikely to be effective, and ongoing problems associated with very low interest rates cannot be ignored.
- Though Canadian fiscal authorities have some room to manoeuvre, both the limitations of discretionary fiscal policy and longer-term budgetary challenges suggest that fiscal policy will not add to Canada's growth in the next few years.
- Given the continued slow pace of the global economic recovery, a significant rebound in Canadian private demand is unlikely in the near future. High household debt suggests that consumption is an unlikely source of near-term growth. An investment revival will require a return of corporate confidence, while an export rally will depend on a strong and sustained foreign recovery.
- Canadian policymakers should therefore accept the likely continuation of Canada's slow-growth recovery for the next few years. Their focus should be on addressing the burden of this slow growth, which falls mostly on unemployed and underemployed Canadians.
- To address this burden, policymakers should consider reforms to enhance income support for the unemployed, increase the mobility of workers and improve incentives for labour-market training.

Monetary Policy Is At or Near Its Limit

Monetary policy became highly expansionary in major developed economies in mid-2008 and remains so today. By early 2009, central banks' policy interest rates had reached their effective lower bounds, soon after which the US Federal Reserve and the Bank of England began their policies of Credit and Quantitative Easing (QE),

both of which led to enormous increases in their balance sheets (Kozicki et al., 2011).[1] For its part, the European Central Bank (ECB) was less aggressive in its initial rate reductions and was more constrained in balance-sheet expansions, but it nonetheless provided enormous liquidity support to the commercial banks in its jurisdiction.

As of summer 2014, there is no indication that the Bank of England will soon be reversing its QE actions, although it may soon begin raising its policy interest rate. In the United States, the Federal Reserve has started "tapering" its monthly asset purchases, but actual contraction of its balance sheet still appears to be a year or more away. In Europe, the ongoing sovereign debt crises and relative economic stagnation suggest that the ECB will continue its current level of monetary engagement for some time. In short, monetary policy in these three major economies is more-or-less flat out and is likely to remain very expansionary for an extended period.

The Bank of Canada acted early to reduce its policy interest rate – and did so aggressively. By April 21, 2009, the Bank's target for the overnight interest rate had reached 0.25 percent, its effective lower bound. The Bank prepared for, and clearly communicated, the possibility that it may need to engage in Credit or Quantitative Easing, but these actions ultimately were deemed unnecessary.

The Bank did, however, pioneer the use of a "conditional commitment" whereby it stated that its policy interest rate would remain at its lower bound until the summer of 2010, so long as inflationary pressures did not emerge (Bank of Canada 2009). Between June and September 2010, amid emerging economic recoveries in Canada and abroad, the Bank of Canada raised its target for the overnight interest rate to 1.0 percent, where it remains today.

For four years, the Bank of Canada has held its key policy interest rate unchanged but has nonetheless varied its central message considerably. As the speed of the global recovery picked up in 2011-2012 and then slowed again in 2013-2014, the Bank modified its policy stance – from displaying a clear "tightening bias" in the earlier part of the period to displaying a more "neutral" stance by the summer of 2014.

Macroeconomic policymakers should not be looking to the Bank of Canada to provide any further stimulus to the economy for two reasons. The first is that we have likely reached the point where further monetary expansion would have little or no effect on aggregate demand – that is, monetary policy may now be akin to "pushing on a string." With a great deal of uncertainty about the pace of the global recovery, including slowing growth in Asia, continued financial tensions in Europe and ongoing debate about the nature and pace of fiscal consolidation in the United States, Canadian firms may simply be delaying their significant investment decisions.

In this environment, the crucial binding constraint on investment behaviour is not the real interest rate or even access to financial capital but rather firms' uncertainty regarding the future state of the economy. In its April 2013 *Monetary Policy Report*, the Bank of Canada reported that more than two-thirds of Canadian firms claimed deficient demand, sector-specific issues, and taxes and regulations were primarily affecting their investment decisions. Only 10 percent suggested that access to credit was an important issue (Bank

1 Though definitions for these terms lack unanimity, those used by the Bank of Canada (2009) are becoming standard. Credit easing refers to a central bank's purchases of non-government securities (sometimes with "sterilizing" sales of government securities), intended mostly to reduce specific credit spreads. Quantitative easing refers to a central bank's "unsterilized" purchases of government securities, designed to increase the monetary base and reduce overall interest rates.

of Canada 2013a). The situation had not improved materially a year later. The Bank's April 2014 *Business Outlook Survey* stated that "many businesses continue to report that uncertainty – most often related to domestic demand or, in some cases, sector-specific or regulatory factors – is leading them to delay or shift the focus of their investment plans" (Bank of Canada 2014a).

During 2013, while the US Congress was deadlocked in a battle over raising the federal debt ceiling, Federal Reserve Bank of Dallas President Richard Fisher applied this argument to the US economy. Fisher noted the precariousness of the global economy but emphasized the lack of confidence created by the failure of the US government to implement a clear and coherent fiscal plan:

> .... Decision-making under conditions of uncertainty is always a challenge for businesses; decision-making in a thick fog of uncertainty is well-nigh impossible. It negates the power of hyper-accommodative monetary policy to propel our economic vessel forward. .... I argue that the Fed has no hope of moving the economy to full employment, despite having pulled out all the stops on the monetary front, unless our fiscal authorities get their act together. (Fisher 2013, pp. 5-6)

The challenges in Canada are not precisely the same: the federal government is in the enviable position of having a much lower debt-to-GDP ratio than the US and is currently en route to a balanced budget by the 2015/16 fiscal year, if not sooner. However, since exports to the US are so important to Canadian firms, the lingering fiscal uncertainty there contributes to the ineffectiveness of Canadian monetary policy. In other words, further reductions in the policy interest rate by the Bank of Canada together with the depreciation of the Canadian dollar that typically results from such action would be unlikely to provide significant stimulus to either Canadian investment or exports.

In the current economic environment, the real interest rate and the Canadian-US exchange rate are not the crucial binding constraints for firms. A sustained recovery in investment and exports will require a genuine recovery of confidence in the US and global economies.

The second reason why policymakers should not be looking to the Bank of Canada for further stimulus, quite apart from whether such action would be effective, is the considerable costs associated with keeping interest rates at very low levels for long periods of time. White (2012) has provided the argument in the general case while Masson (2013) has applied it to the Canadian situation.

White (2012) acknowledges that the massive monetary expansion following the onset of the global financial crisis was the right policy action, though he also believes that the Bank of Canada and other central banks should have paid closer attention to the growing financial imbalances before the crisis and that their policies should have involved more "leaning" against those imbalances through higher interest rates (White 2009). White clearly believes there are dangers associated with a continuance of "ultra-easy" monetary policy, including an over-emphasis on particular types of investment (such as residential housing), a tendency for investors to adopt excessively risky positions in pursuit of higher yields and a lack of fiscal discipline imposed on over-indebted governments. In his view, sustained low interest rates provide a genuine threat to financial stability.

For the Canadian context, Masson (2013) argues that sustained ultra-low interest rates are contributing to a run-up in household debt and that a large number of Canadian households will be in a strained financial situation when interest rates eventually increase (Bank of Canada 2012). He also notes that low Canadian mortgage rates have fuelled a 20 percent increase in house prices since their brief decline in March 2009 and that a significant correction remains an important risk – a risk taken seriously by the International Monetary Fund (IMF 2014b). Furthermore, both Masson and the IMF note that since the government-owned Canada Mortgage and Housing Corporation is

by far the country's largest provider of mortgage insurance, taxpayers are exposed to significant potential losses in the event that house prices decline sharply.

This precarious economic combination – growing household debt, high and rising house prices and taxpayers' considerable exposure on mortgage insurance – has led the Government of Canada several times in the past few years to tighten up the terms and conditions on residential mortgages and to restrict access to government-backed mortgage insurance. These policies are an effective substitute for a tightening of monetary policy in a situation where the growing financial imbalances are concentrated in the residential real estate market (Boivin, Lane and Meh 2010). However, if the financial imbalances grow further or become more widespread, monetary tightening will likely become the preferred policy action.

There is an evident tension between the appropriate monetary policy necessary to support aggregate demand and that needed to promote financial stability. The history of financial crises (Galbraith 1993; Kindleberger and Aliber 2005; Reinhart and Rogoff 2009; Johnson and Quak 2010) shows clearly that highly leveraged (i.e., indebted) households, non-financial firms and banks play a central role in their causes and propagation. To the extent that sustained low interest rates contribute to such indebtedness, they are part of the problem behind the creation of financial instability.

On the other hand, in the wake of a financial crisis, when the flow of credit naturally falls as part of the deleveraging process and widespread pessimism contributes to a weakening of aggregate demand, low interest rates are a vital part of the policy package designed to return the economy to some sense of normality (Blanchard et al. 2010). Getting the right balance for monetary policy is difficult and requires a careful assessment of both the benefits and costs of any particular interest-rate policy.

In summary, the Bank of Canada's ongoing support of aggregate demand through ultra-low interest rates is likely a policy whose benefit-cost ratio has declined sharply over the past five years. In the first few years of the global financial crisis, expansionary monetary policy working in concert with expansionary fiscal policy (in Canada and elsewhere) supported aggregate demand and dampened the recessionary effects on output and employment. Five years later, however, when sluggish growth and considerable uncertainty are the dominant concerns for Canadian firms and households, and access to credit is not an important constraint, the effect of further rate reductions on Canadian output and employment is likely to be very small.

At the same time, the costs of maintaining rates at ultra-low levels are now becoming apparent. If household debt and house prices continue to rise, and further tightening of mortgage terms becomes politically infeasible, it may become necessary for the Bank of Canada to raise its policy interest rate.[2]

Canadian Fiscal Policy Has Limited Room to Manoeuvre

As mentioned above, the G20 countries embarked on considerable fiscal expansion in the first two

2 I have omitted any discussion of the possibility of "unconventional" expansionary monetary policy in Canada, such as the direct purchase of government securities with newly created money (Quantitative Easing). Such a policy would be pursued presumably only if further monetary stimulus were deemed necessary when the Bank of Canada's target for the overnight interest rate was already at its effective lower bound (0.25 percent). Given the current and probable context for the next few years, such a situation is quite unlikely.

years of the global financial crisis. When the signs of economic recovery first emerged in late 2009 and early 2010, Canada took the opportunity as host of the G20 summit in Toronto to stress the importance of fiscal consolidation and to recommend a quick return to balanced budgets after the two years of planned fiscal stimulus had run their course (G20, 2010).

The start of fiscal consolidation appeared to be sensible in the midst of an emerging recovery. But with the onset of the sovereign debt crises in Europe, which began in Greece in early 2010 but then spread quickly to other countries, one can now argue that it was a policy either slightly ahead of its time or implemented with a little too much zeal. A kinder assessment might be that fiscal consolidation was simply "more effective" than many expected (Blanchard and Leigh 2013).

Whatever the general case for such fiscal austerity, it is clear that Canada's public finances are in considerably better shape than those in the United States, the United Kingdom and the other major European countries. But this is a recent phenomenon that stems from the corrective actions taken provincially and federally after Canada was seen by many to hit its debt wall in the mid-1990s.

For the consolidated government sector in Canada, total spending fell from one-half (49.9 percent) of GDP in 1992 to a little more than one-third (35.8 percent) by 2007, while total revenues fell from 41.6 percent to 37.5 percent over the same period (Ragan 2012).[3] Furthermore, strong US and world economic growth during this period permitted Canada's fiscal consolidation to occur with only a limited contractionary effect on the domestic economy.

As a result, the swift decline in budget deficits, together with healthy GDP growth, produced a sharply falling debt-to-GDP ratio. For the federal and provincial governments combined, the net debt-to-GDP ratio fell from a peak of 92 percent in 1996 to a low of 37 percent just before the onset of the global financial crisis. The IMF now projects that by the end of 2015 Canada's net debt-to-GDP ratio (for federal and provincial governments combined) will have increased by only 17.5 percentage points above its 2008 level, at which point it will still be well below the debt ratios of most other advanced economies (IMF 2014c).

Despite Canada's relatively sound public finances, policymakers should not be looking to fiscal policy to provide significantly greater stimulus to aggregate demand. Despite the well-known limitations of discretionary fiscal policy as a stabilization tool, it can be quite successful in dampening a sudden and significant economic collapse (Blanchard et al. 2010). The many imperfections of fiscal stimulus can be ignored in such situations since there is a recognized need to place a floor under collapsing demand and confidence.

But fiscal stimulus is not the most effective tool for enhancing growth during the calmer periods of economic recovery. During these times, such as the interval from 2011 to today in Canada, fiscal policy is best left to focus on determining the nation's longer-term spending priorities and designing an efficient and effective tax system to raise the necessary funds. Of course, these priorities could include spending on crucial public infrastructure, which would have both short-run effects on aggregate demand and longer-run effects on the country's growth potential. Whatever spending is

3 Reduced debt-service costs (through lower interest rates) also contributed to the reductions in budget deficits. See Kneebone and Chung (2004) for the relevant decomposition at the federal level. The data cited here omit the influence of CPP/QPP contributions and benefits.

deemed appropriate, however, should be determined in a deliberate and coherent decisionmaking process, one unlikely to be timely enough to respond to today's concerns of cyclically slow growth.

There is a second reason why Canadian governments should retain their current objectives for returning to balanced budgets and thereby avoid any significant new measures of fiscal stimulus. The aging of Canada's population, caused both by increasing longevity and falling fertility rates, will create serious fiscal challenges over the next few decades. This "fiscal squeeze" will see significant increases in the share of national income devoted to age-related expenditures such as healthcare and elderly benefits (Robson 2010; Ragan 2012). Even with moderate rates of economic growth and tax revenues, financing these expenditures will require some combination of tax increases, cuts in other expenditures and increased government borrowing. Canadian governments will be much better placed to deal with this looming fiscal squeeze if their debt-to-GDP ratios are kept relatively low over the next few years.[4]

In summary, Canada's relatively low debt-to-GDP ratio shows that the federal government has the fiscal room to be modestly more expansionary should the need arise, a point the IMF recently emphasized (IMF 2014b). Political concerns have driven the government to aim for a balanced budget before the federal election in late 2015, and these concerns are understandable. In contrast, the underlying economic situation is less sensitive to timing. If the return to a balanced budget is delayed by a year or two, with higher spending and/or lower tax revenues along the way, the government's overall fiscal position changes only slightly.

Despite this fiscal flexibility, the well-known limitations in the use of discretionary fiscal stabilization, combined with the future budgetary challenges associated with an aging population, make a compelling case for Canadian governments to avoid further significant fiscal stimulus. If Canadian governments take strong actions to ensure a return to balanced budgets over the next few years, fiscal policy will actually detract from Canada's rate of economic growth; if they take more relaxed paths back toward balance, their actions will at best be neutral for growth. Only in the very unlikely case of renewed fiscal stimulus will fiscal policy actually make a positive contribution to growth.[5]

A Timely Rebound of Private Demand?

The previous two sections argued that little further expansionary actions should be expected from either the Bank of Canada or various fiscal authorities. This is one reason why senior Canadian officials have said repeatedly in recent months that it is time for the private sector to take up the challenge of increasing Canadian economic growth. For example, Carney (2013), Macklem (2013a) and Poloz (2014) all state that a medium-term pickup in growth depends on a recovery of both domestic investment and exports. What obstacles might stand in the way of such a private-sector recovery?

4 Of course, small budget deficits are consistent with a gently declining debt-to-GDP ratio in a growing economy. Therefore, there is nothing economically crucial about exactly balancing either federal or provincial budgets in the next few years.

5 Some reviewers of this *Commentary* argued that a renewed infrastructure spending commitment could both stimulate aggregate demand and avoid the usual problems associated with discretionary fiscal policy. The long-term case for such spending may be strong, but the considerable time lags required to spend prudently on sensible projects may make it poorly suited to our current cyclical challenges.

Deleveraging and Sluggish Recoveries

In several academic papers and a celebrated post-2008 book, professors Carmen Reinhart and Kenneth Rogoff have explored the causes, propagation and aftermath of financial crises spanning 800 years. A central finding from their research, emphasized in Reinhart and Rogoff (2008, 2009) and also in Reinhart and Reinhart (2010), is that recoveries from financial crises are typically much slower than recoveries from "normal" recessions – those in which the collapse of financial institutions and dysfunction in financial markets do not play a leading role.

The authors emphasize two reasons for the slow recoveries from financial crises. First, the collapse of large financial institutions and the associated panic saps confidence and provides sound justification for firms to delay investment and hiring decisions and for households to put off large spending decisions. Any delay in such spending naturally leads to a slowing of aggregate demand and can be an important contributor to a slow-growth economy, at least over the short and medium runs.

Second, and probably more important, recovery from a financial crisis almost always requires a process of "deleveraging" among those entities that incurred substantial debt to purchase assets and then suffered large declines in the market values of those investments. When households and non-financial firms deleverage, they slow their demand for credit and, thus, for goods and services. When the banking sector begins to deleverage, either through voluntary actions or in response to more stringent legislated capital requirements, it reverses its usual role of credit expansion and becomes instead a vehicle of credit contraction. Since credit in a modern economy is a crucial input to firms' production processes and also plays a central role in facilitating corporate and household demand, the restriction in credit flows naturally results in a slowing of the economy's growth rate.

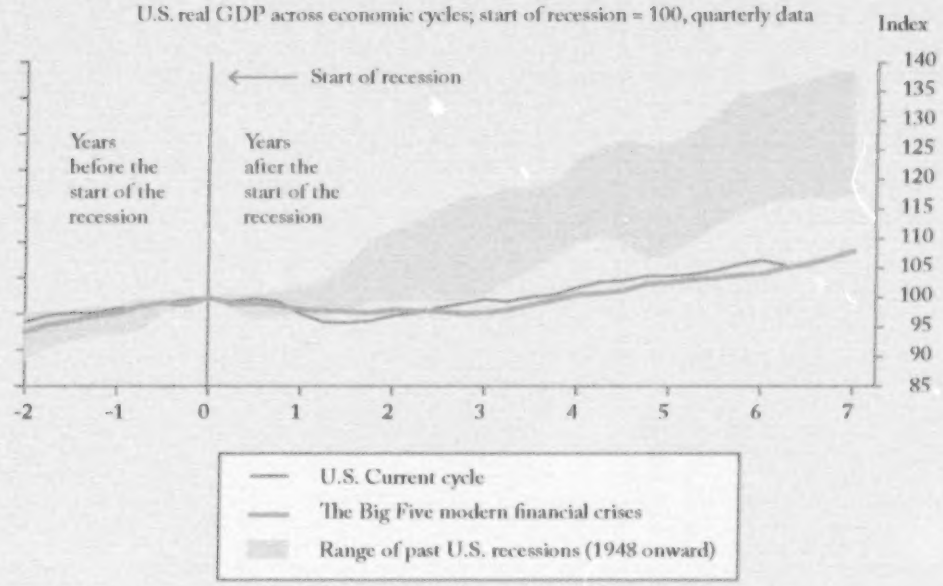
By this logic, a slow-growth recovery following a financial crisis lasts as long as it takes for a return of corporate and household confidence and for the deleveraging process, among individual investors and financial institutions alike, to fully run its course. Gradual improvements in balance sheets, confidence and overall economic conditions can generate a virtuous cycle, just as their opposites can interact and produce a vicious downward spiral at earlier stages of a financial crisis.

Bank of Canada Governor Stephen Poloz has referred to the economic "trauma" generated by the recession and the need for "reconstruction" now, suggesting a recovery process similar to that following a war (Poloz 2013). And he is correct. Although no hostile destruction of physical assets occurred in Canada as a result of the global financial crisis, the sustained lack of confidence and dysfunction of credit markets can be remarkably damaging to modern economies.

Figures 1a and 1b, reproduced from the Bank of Canada's *Monetary Policy Report*, illustrate the slow pace of the economic recoveries in the United States and the euro-zone, especially as compared to past "normal" recoveries. The range of recoveries in real GDP (from 1948 for the United States and from 1980 for the euro-zone) is shown in each figure by the grey shaded area; the red lines show the paths of real GDP in the current recoveries. For the United States, six years after the start of the recession, real GDP is roughly 20 percent below the mid-point of the shaded area, and is even well below the area's lower bound. For the euro-zone, real GDP is 15 percent below the mid-point of the shaded area and also well below the lower bound. By this simple but sensible measure, there is no question that the current economic recoveries in the United States and in the euro-zone are well below the typical pace.

The two current recoveries look much less unusual, however, if we compare them to the recovery paths after what Reinhart and Rogoff (2008) call "The Big Five" modern financial crises (shown as the blue lines in the two figures). For the United States, the recovery of real GDP is almost exactly coincident with the recovery path following

Figure 1a: The Slow Pace of the US Recovery



Note: The Big Five modern financial crises, as described in Reinhart and Rogoff (2008), are Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1992). See C.M. Reinhart and K.S. Rogoff, "Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison," *American Economic Review: Papers and Proceedings* 98, no. 2 (2008): 339–44.

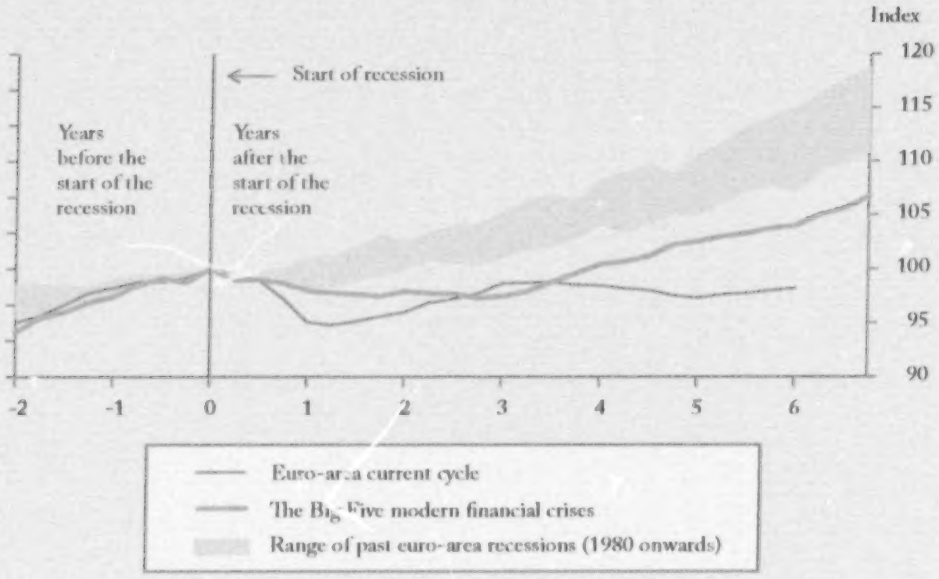
Sources: U.S. Bureau of Economic Analysis, Organisation for Economic Co-operation and Development, and Bank of Canada. This chart updates one which originally appeared as Chart 7 in Bank of Canada, *Monetary Policy Report*, July 2012 and the author is grateful to the Bank for assistance in reproducing the chart.

the Big Five; for the euro-zone, however, given the sovereign debt crises and difficult fiscal adjustments that continue to plague those countries, the current recovery is slower and considerably less regular.

With the levels of real output in the United States and Europe so far below the level one would expect six years after the onset of a "normal" recession, it might be natural to expect that growth rates would soon pick up and generate a rebound of output inside the shaded areas. Although this could happen, it is unlikely to do so in the next few years. Confirming the pessimism inherent in the Reinhart and Rogoff view of post-financial-crises recoveries, the most recent IMF forecasts (IMF 2014c) show rising but still only modest growth rates in the major economic regions of the world through 2014 and 2015 (see Table 1 below). The United States is the one exception that shows a forecast GDP

Figure 1b: The Slow Pace of the European Recovery

Euro-area real GDP across economic cycles, start of recession = 100, quarterly data



Note: The Big Five modern financial crises, as described in Reinhart and Rogoff (2008), are Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1992). See C.M. Reinhart and K.S. Rogoff, "Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison," *American Economic Review: Papers and Proceedings* 98, no. 2 (2008): 339–44.

Sources: Eurostat, Organisation for Economic Co-operation and Development, and Bank of Canada. This chart updates one which originally appeared as Chart 6 in Bank of Canada, *Monetary Policy Report*, July 2012 and the author is grateful to the Bank for assistance in reproducing the chart.

growth rate for these two years close to what might be considered a pre-recession norm.[6]

In particular, note that the recession in the overall euro-zone that ended in late 2013 is forecast to be followed by two years of growth rates at 1.5 percent or below. The United Kingdom is

6 The 1996–2005 average growth rates are shown here as an approximation to "normal" growth rates. However, it is useful to note that demographic forces in most developed countries (especially the aging of the Baby Boom generation) are projected to cause a slight decline in growth for the next few decades. When expressed as annual growth rates, this demographic effect is much smaller than the differences apparent in Table 1. See Ragan (2012) for more discussion of these demographic forces.

predicted to see a significant growth improvement for 2014, but with a drop again in 2015. Japan is predicted to have modest growth in 2014, due mostly to its recent highly accommodative policies, but the sluggishness elsewhere in Europe and Asia will bring its growth back to 1 percent by 2015. The seven countries grouped together as Emerging and Developing Asia (China, India, Indonesia, Malaysia, Philippines, Thailand and Vietnam) will have growth just below 7 percent annually, dragged down by a decline in China's and India's growth relative to their pre-2008 rates.

Table 1 also shows the IMF's growth forecasts for Canada. Its relatively slow growth during 2013 is forecast to increase moderately in 2014, mostly as a result of the more healthy US recovery. But even the forecast growth rates for 2014 and 2015 are well below the pre-2008 norm; in the decade from 1996 to 2005, for example, real GDP growth in Canada averaged 3.3 percent annually. And there is nothing especially pessimistic about the IMF's Canadian forecasts; the most recent ones from the Bank of Canada and TD Economics are very similar (Bank of Canada 2014b; TD Economics 2014).

Consumption, Investment or Exports?

The modest growth likely to occur in Canada in 2014 and 2015 underlines the importance of a healthy recovery in Canadian private demand. From the perspective of simple national accounting, this logic is inescapable: if Canadian governments cannot be expected to contribute much through their fiscal policies to future growth because they are currently in the process of returning to balanced budgets, then increases in overall growth can occur only if the other components of aggregate expenditure – consumption, investment and net exports – make healthy recoveries. This simple observation begs the question of whether there is any good reason to expect such healthy recoveries. If not, then the prospects for significantly higher overall growth must also be poor.

Begin with aggregate consumption. We have heard much in recent years about how rising Canadian consumer spending, fuelled in part by very low interest rates, has led to rising household indebtedness, which has increased from about 80 percent of disposable income in 1990 to about 150 percent today. Canadian households are now more indebted than their US counterparts, admittedly after the latter experienced four years of necessary and significant deleveraging (Bank of Canada 2012; TD Economics 2013).

The most basic problem with high household debt is that many households who can comfortably service their debt at low interest rates may have serious problems when interest rates eventually rise. Interest rates on personal lines of credit and home mortgages, for example, are likely to rise from the current 2-to-4 percent range to 5 to 7 percent in a few years, thereby roughly doubling households' debt-service costs. As the Bank of Canada has shown, such interest-rate hikes would increase the fraction of households whose debt-service charges comprise more than 40 percent of their income from 11.5 percent in 2011 to roughly 20 percent by 2016 (Bank of Canada 2012, pp. 20-21).

For households that do encounter problems as interest rates rise, the solution lies either in reducing other expenditures, selling assets to pay down accumulated debt or defaulting on the loans altogether. The last option, if widely used, would have a direct and deleterious effect on the health of the financial system.

A related problem is that much of Canadians' rising household debt consists of mortgages for newly purchased homes whose prices have been rising very rapidly in recent years. Any substantial decline in home prices, which many commentators argue is a serious risk (Madani 2012), would lead to declines in household net worth and possibly to a greater incidence of delinquencies or even mortgage foreclosures by commercial lenders, with obvious implications for the stability of the financial system.

Table 1: Actual and Forecast Annual Growth Rates of Real GDP

Region	1996-2005 (average)	2011	2012	2013	2014 (forecast)	2015 (forecast)
United States	3.4	1.8	2.8	1.9	2.8	3.0
Euro Zone	2.1	1.6	-0.7	-0.5	1.2	1.5
United Kingdom	3.4	1.1	0.3	1.8	2.9	2.5
Japan	1.0	-0.5	1.4	1.5	1.4	1.0
Emerging and Developing Asia	7.1	7.9	6.7	6.5	6.7	6.8
Canada	**3.3**	**2.5**	**1.7**	**2.0**	**2.3**	**2.4**

Source: IMF, *World Economic Outlook*, April 2014 (IMF, 2014a).

The Bank of Canada has often raised general concerns associated with rising household indebtedness; the more specific concern associated with rising home prices has led the government to tighten the terms and conditions on residential mortgages and to restrict access to government-backed mortgage insurance several times in the past few years. These actions were taken to dampen both the upward pressure on home prices and the upward rise in household debt.

Given the high and rising household debt in Canada, it seems unlikely that aggregate consumption could become a major source of greater GDP growth in the next few years. Indeed, in the absence of any increase in the growth of household income, any greater contribution to overall growth from household consumption would probably be undesirable.

Now consider firms' investment in plant and equipment, the second major component of private demand. Economists often stress the importance of the real interest rate as a key determinant of corporate investment decisions, but the past few years have clearly seen very low real interest rates without booming investment.

As John Maynard Keynes argued years ago, firms' expectations of the economy's future state – what he famously called "animal spirits" – are also a crucial determinant of investment, and for good reason. Since firms that purchase plant and equipment today are doing so in the expectation of earning future sales and profits, it is the likely state of the future economy, not today's, that figures most prominently in their calculus.

Periods of uncertainty, and especially pessimism, about the domestic and global economies are thus ideal times for firms to reduce or delay investment plans while they wait and see how the economic environment evolves. Reductions in planned investment spending lead directly to reductions in aggregate demand, with immediate (as well as longer-run) implications for the growth of real GDP.

Such pessimism is reflected in the Bank of Canada's most recent *Business Outlook Survey*,

released in April 2014. While showing some increase in firms' investment intentions over the past year, albeit starting from a very low level, the overall picture remains one of gloominess and uncertainty (Bank of Canada 2014a). An imminent and significant rebound of corporate investment is unlikely.

Finally, consider Canadian exports, the third component of private expenditure. Is it reasonable to expect that export growth will be adequate to generate a return to significantly higher growth for the country as a whole? The primary driver of Canadian exports is the level of economic activity in its main export markets. Traditionally, the United States has been by far the most important of these markets, and though it continues to be Canada's largest customer, others are gradually increasing in relative importance.

A second important driver of Canadian exports is the exchange rate, although here the relationship is more complex. Since the exchange rate is the relative price of two currencies, whose value is determined by various economic events domestically and abroad, it is not possible to draw a simple causal connection from changes in the exchange rate to changes in Canadian export levels. Indeed, understanding the causes of any particular change in export activity is crucial for determining the predicted relationship between exports and aggregate demand (Ragan 2005).

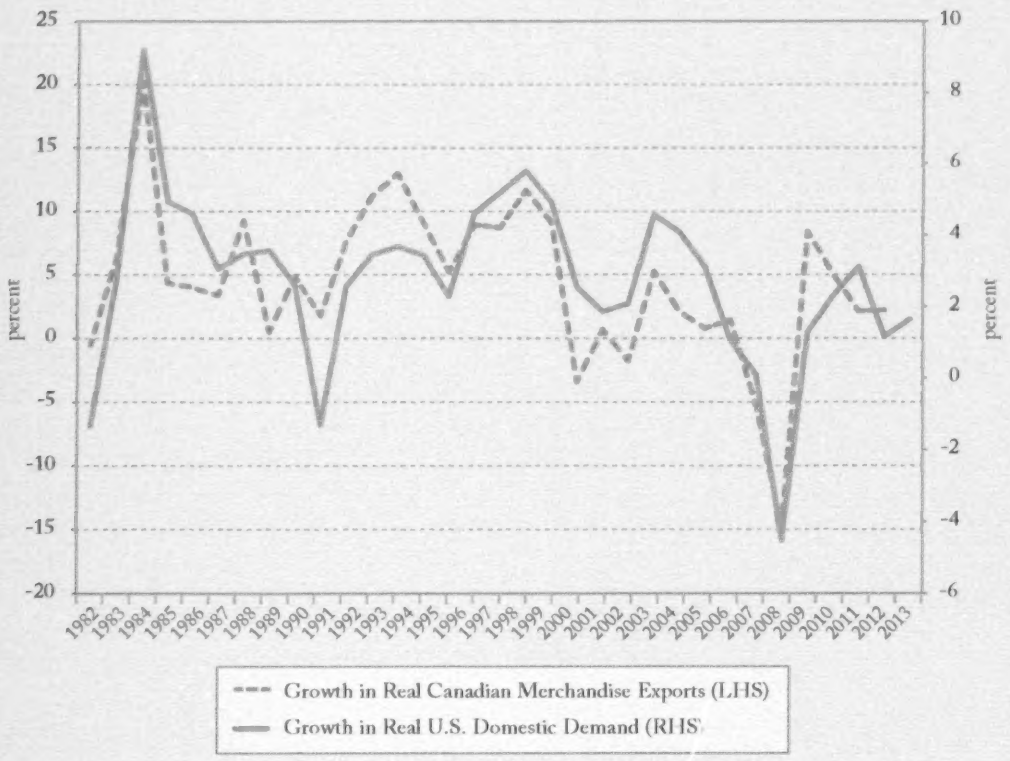
Figure 2 shows the relationship between the growth in real Canadian merchandise exports and the growth of real US domestic demand since 1982, revealing the extent to which a recovery of Canadian exports is likely to rely on an overall US recovery. This close relationship can hardly be surprising, given the geographic proximity of the two economies, as well as the high degree of economic integration in many industries. However, the Bank of Canada (2013a) has noted that the relationship between foreign activity (broader than just in the United States) and Canadian exports has weakened in recent years, suggesting that even a healthy external recovery would lead to a smaller recovery in Canadian exports than what might be suggested by the patterns in Figure 2.

The modest pace of economic recovery in the United States, Europe and elsewhere, combined with a weakening of the structural relationship between foreign activity and Canadian exports, explain why Canadian exports have been so slow to recover. Figure 3 shows how far Canadian exports have deviated from their traditional recovery path. Almost six years after the recession's start, Canadian exports are still roughly $130 billion below the level that would have been observed if the current recovery had resembled the average recovery since 1951 (Macklem 2013b).

The IMF growth forecasts shown above in Table 1 provide only a limited basis from which to expect a significant recovery in Canadian exports over the next few years, although the recent pickup in US growth is surely a favourable indicator. The IMF's modest growth prediction for Japan in 2014 is short-lived, with growth declining markedly in 2015. Its forecast for Europe shows a significant improvement, but given the complexity of both the economic and political forces at play, it is reasonable to view this prediction as optimistic.

Emerging markets offer some hope, although Canadian exports to these countries are so small in absolute terms that enormous increases in growth are required there to generate a significant increase in Canadian exports. The IMF predicts that growth in "Emerging Markets and Developing Economies" will rise slightly from 4.7 percent in 2013 to 5.1 percent in 2014 and 5.4 percent in 2015. This modest increase, however, will likely be insufficient to offset the existing downward pressure on commodity prices, making life more difficult for commodity-exporting countries like Canada (IMF 2013).

Figure 2: The Growth of Canadian Exports and US Domestic Demand



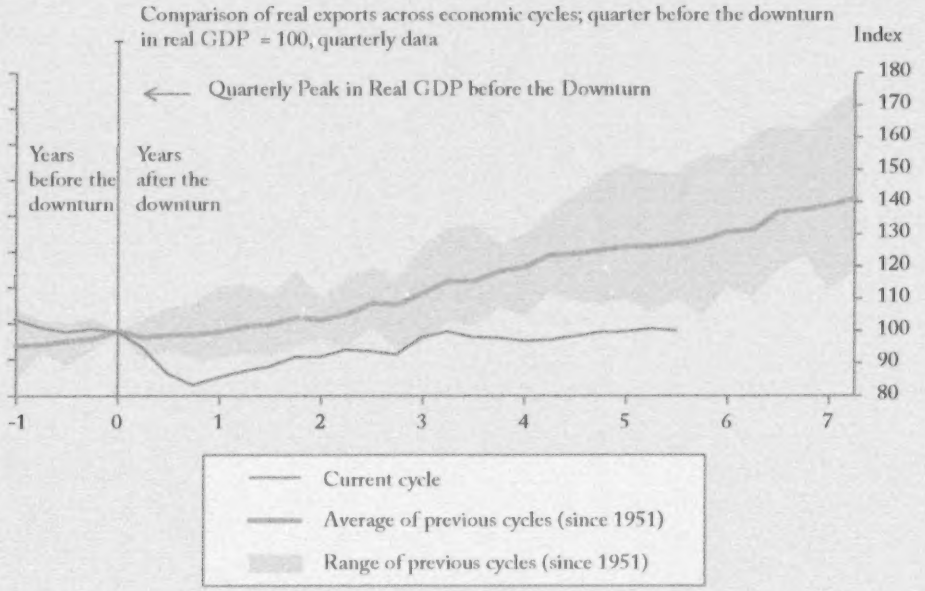
Source: Author's calculations based on data from Statistics Canada and US Bureau of Economic Analysis.

A Sobering Summation

More than five years into a "normal" recovery is when most economies are growing healthily and beginning to sow the seeds of their next recession. But in the aftermath of a financial crisis, the pace of recovery is much slower, as emphasized by Reinhart and Rogoff (2008, 2009). Although most of the economic damage during the financial crisis occurred outside Canada, existing global forces nonetheless have had a profound effect on Canada. The contractionary effects of massive deleveraging, ongoing household and corporate pessimism, and the considerable uncertainty that remains within Europe, the emerging economies and even within the United States, have combined to produce an economic environment in which investment incentives and demand for Canadian exports are both sub-par. In such a world, there is no compelling reason to expect Canadian private demand to recover. Until there is a healthy and sustained recovery in the global economy, Canadian investment and exports will likely disappoint.

The implication of this conclusion, combined with the earlier one that Canadian monetary and fiscal policies cannot be expected to be the engines of greater growth, is quite stark. If private demand cannot be relied upon for more growth,

Figure 3: The Slow Recovery of Canadian Exports



Sources: Statistics Canada and Bank of Canada. This chart updates one which originally appeared as Chart 26 in Bank of Canada, *Monetary Policy Report*, July 2013 and the author is grateful to the Bank for assistance in reproducing the chart.

and conventional Canadian macro policy tools are at their practical limits in terms of stimulating aggregate demand, we need to recognize that slow growth is an inevitable part of our near-term future. As a result, we need to focus our attention on the burden of a slow-growth recovery.

The Burden of a Slow-Growth Recovery

Ben Bernanke, the former Chair of the US Federal Reserve, argued convincingly for several years that a central problem with a slow-growth recovery is that, even when aggregate output is increasing and the economy technically out of recession, growth may not be fast enough to absorb ongoing increases in the labour force, let alone to regain all the jobs lost during the previous recession. Bernanke (2012) emphasizes the slow US employment growth following 2009 and especially the uncharacteristic increase in the incidence of long-term unemployment. For their part, Lazear and Spletzer (2012) argue that long-run or "structural" problems are not the fundamental cause of recent high US unemployment; instead, the cause appears to be short-run "cyclic phenomena that are more pronounced during the current recession than in prior recessions."

With the United States at the centre of the global financial crisis, it is not surprising that labour-market challenges there are more acute than in Canada. But the same basic phenomenon exists on both sides of the border: output growth may be insufficient to replace lost jobs while at the same time absorbing ongoing population and labour force growth.

Canadian Employment and Output

Canadian officials have been promoting the country's exemplary macroeconomic record since 2009, citing increases in real GDP and aggregate employment greater than in most other OECD countries. As Stanford (2012) has rightly pointed out, however, such international comparisons of aggregate growth rates make little sense unless the countries have similar population growth rates. As it turns out, Canada has significantly faster population (and labour force) growth than most developed economies and, hence, it does not follow that our more rapid growth in real GDP and employment necessarily translates into faster growth in living standards. If our focus is on the performance of average material living standards since the recovery began in 2009, it is best to examine the patterns in real per capita GDP and the employment-population rate. Stanford (2012) shows that once such adjustments are made, Canada's recovery looks considerably more mediocre.

Figure 4 shows the paths of aggregate employment and the employment-population rate in Canada since 2005. In the years before 2008, both series are rising, as expected in a booming economy. Both then fall sharply in 2009 as the recession takes hold. But note that while aggregate employment recovered relatively quickly and reached its pre-recession peak by the third quarter of 2010, the employment rate is recovering much more slowly. By early 2014, the employment rate had still progressed only half way to its pre-recession peak and was equal only to its early 2005 value.[7] The failure of the employment rate to fully recover indicates that while the Canadian economy successfully created many new jobs since the recession's nadir in 2009, employment has not grown fast enough to make up for both the recessionary losses and absorb the subsequent population increase.[8]

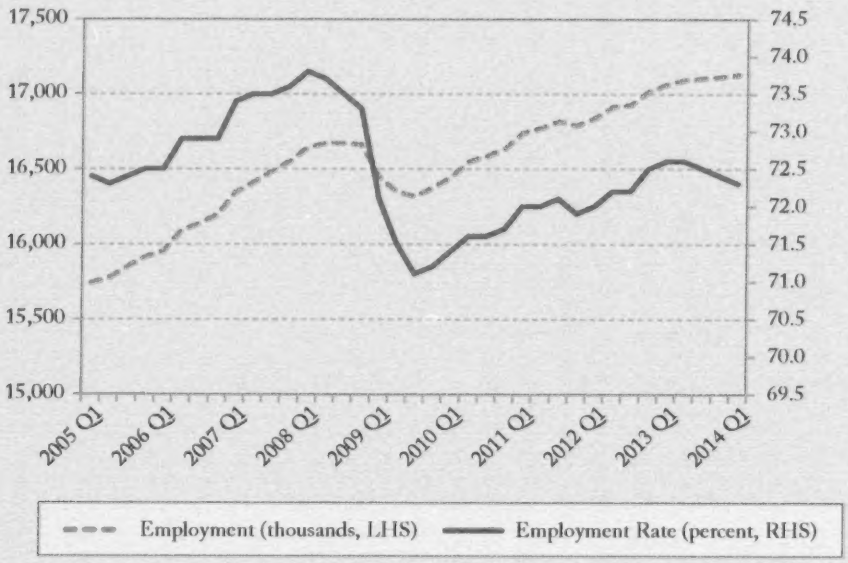
This divergence in the path of aggregate employment from that of the employment-population rate is naturally mirrored in the divergence between the path of real GDP and that of per capita GDP, as shown in Figure 5. Both GDP and per capita GDP declined sharply during the recession, although ongoing population growth explains the larger drop in the latter. Real GDP then recovered relatively quickly and reached its pre-recession peak by the third quarter of 2010. It has grown modestly since then at an average annual rate of about 2.3 percent. With ongoing growth in the Canadian population, the recovery in per capita GDP is necessarily slower than that of overall GDP.

By early 2014, however, the slow GDP growth meant that per capita GDP was just slightly above its peak from five years earlier. Furthermore, per capita GDP is currently 2 to 3 percent below the level it would have reached had it continued unabated on its trend from the mid to late-2000s. The upshot is that – despite modest real GDP growth since 2009 – the increase has not been fast enough to fully absorb the growing population or to return per capita GDP to its pre-recession path. This sluggishness in per capita GDP growth is the aggregate manifestation of the burden of our relatively slow economic recovery.

7 The employment rate in Figure 4 is the ratio of employment to the population for individuals aged 15-64. If it is instead computed using all individuals 15 and over, the recovery in the employment rate is considerably weaker, reflecting the exit from the labour force as individuals retire.

8 The employment data in Figure 4 represent the sum of full-time and part-time employment. While total employment fell in 2009, part-time employment actually increased. And while total employment reached its pre-recession peak by the third quarter of 2010, full-time employment did not fully recover in this sense until early 2011.

Figure 4: Canadian Employment and Employment Rate, 2005-2014, Age 15-64



Source: Author's calculations based on data from Statistics Canada, Labour Force Survey, Table 282-0087.

The Recessionary Burden

Recessions and slow recoveries would be much less serious events if all Canadians shared the burdens equally. Following the logic of Lucas (1987), a typical Canadian's utility would not fall by much if he or she experienced a 3 percent income reduction, lasting for approximately a year, followed by a recovery that within a few years brought income back to its pre-recession growth path. Of course, real-world recessions do not fit this description.

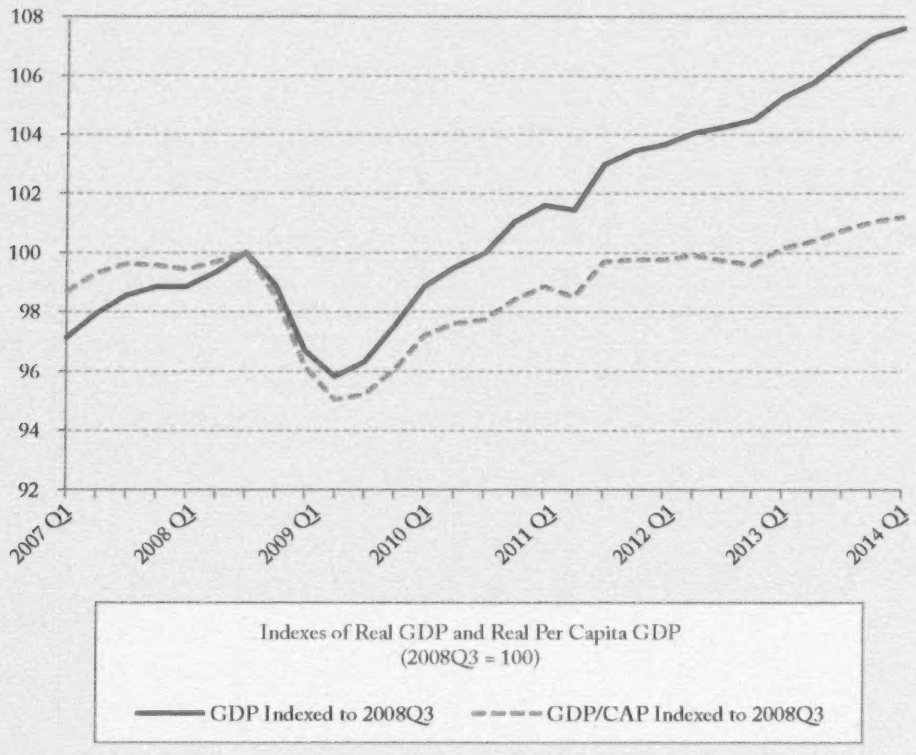
The central problem of actual recessions is not that there is a significant decline in average income, but rather that the burden of economic decline is distributed across the population in a highly unequal fashion. In actual recessions, the vast majority of the population experiences little or no change in real income; at the same time, a small segment of the population loses most or all of their income for a period of up to a few years, and some very unlucky people lose it for even longer.

The burden of recessions and slow economic recoveries is likely to fall disproportionately on four groups. First are those individuals unlucky enough to lose their jobs and incomes as a result of the economic downturn, but who gain re-employment within a relatively short period of time. Their burden is the loss of income until they get hired at jobs that pay as well as the ones they initially lost.

The second group includes the young or new entrants to the labour force who remain unemployed for long periods as a result of the weakness in the labour market. Their burden is the loss of income and lasts until they find their first jobs, the quality of which may be reduced by their extended time in the unemployment pool.

Third are those who find a new job but only one that is of lower quality than what they desire.

Figure 5: Canadian GDP and Per Capita GDP Indexes, 2007-2014



Source: Author's calculations (indexes: 2008Q3 = 100) based on data from Statistics Canada, Table 380-0064 (Real GDP) and Table 051-0005 (Population).

Empirically, this group is often identified as involuntary part-time workers.[9]

The final group includes individuals who remain unemployed for an extended period of time, unable to find any job or one appropriate to their skills. Their burden is both the loss of income they experience as well as the likely degradation of their skills and reduced employability that often accompany long-term unemployment.[10]

The genuine burden of a slow-growth recovery is thus found in different data than those shown in Figures 5 and 6, both of which show the paths of

9 This identification is admittedly incomplete. There are also many workers in full-time jobs who seek better jobs than the ones they currently have.

10 I have omitted the indirect or longer-term social costs associated with unemployment or underemployment, including possible effects on broader social cohesion. These social costs are significant and can be truly devastating in the case of individuals who are unemployed for long periods of time (Blinder 1988; Dao and Loungani 2010).

aggregate data but provide no information about the situation faced by these four specific groups. Figure 6 shows three alternative measures of the unemployment rate. The bottom line in the Figure is the conventional unemployment rate, which shows that after rising quickly from 6 percent to more than 8 percent, it has gradually declined to just over 7 percent today. By this measure, the Canadian labour market has recovered more than halfway from the depth of the recession, but still has a considerable way to go.

A major difficulty with conventionally measured unemployment rates is that a decline may occur because people stop looking for work, thereby dropping out of the measured labour force after becoming discouraged at their inability to find a job. Other non-working individuals may desire work but may not search at all because they are awaiting recall to their previous jobs.

The middle line in Figure 6 shows a more comprehensive measure of unemployment, which adds discouraged workers to the conventional measure as well as those waiting for recall and some fraction of individuals who are involuntarily working at part-time jobs (what Statistics Canada calls the "R8" measure of unemployment). This combined number is often referred to as the overall underutilization rate (Gilmore and LaRochelle-Côté 2011) and is obviously higher than the conventional unemployment rate. For Canada, however, the underutilization rate displays the similar recession-recovery pattern: after rising quickly from more than 8 percent to almost 12 percent in early 2009, it has gradually declined to about 10 percent today. Like the conventional unemployment rate, the R8 rate shows an ongoing but still incomplete recovery.

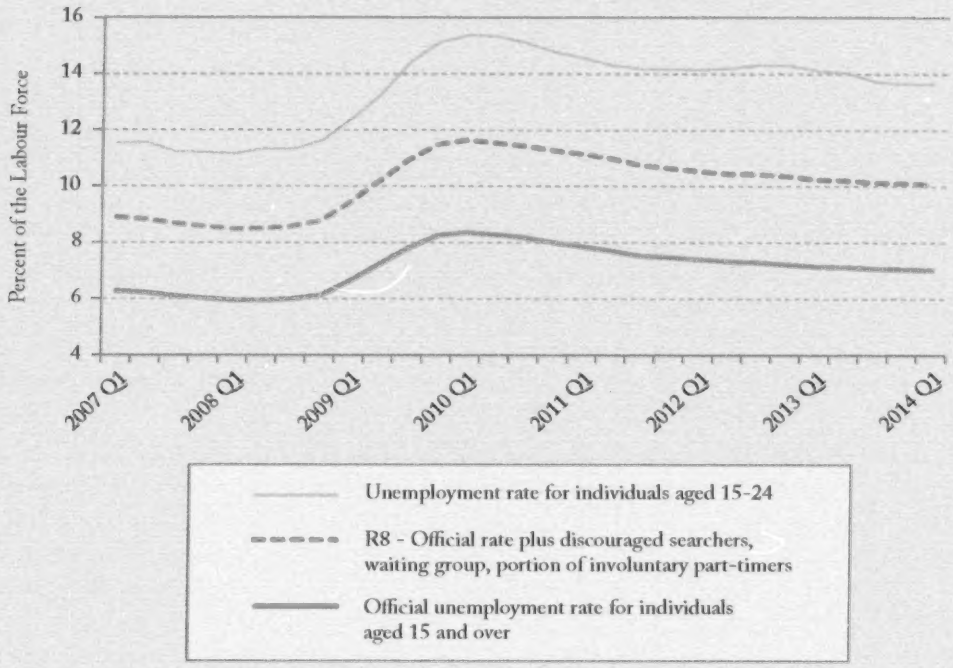
The top line in Figure 6 shows the unemployment rate for Canadians aged 15 to 24. The OECD (2013) has recently emphasized the problems associated with high youth unemployment, especially in European countries where the situation is acute. But even in Canada we should take note of the larger recessionary burden that falls on unemployed young people, not simply because a considerably higher fraction of them are unemployed (which is typically the case) but also because their inability to acquire a job early in their career may have a significantly negative effect on the accumulation of human capital and, thus, on future employment and earnings prospects (Dao and Loungani 2010). Whereas the first two measures of unemployment in Figure 6 are currently about one percentage point above their average values from 2007-2008, the youth unemployment rate is about three percentage points above its pre-recession level and for three years has shown no tendency to decline below its current value of about 14 percent.[11]

Figure 7 shows the large impact of Canada's slow-growth recovery on two other groups. The solid line indicates the fraction of part-time workers who are involuntarily in that state – they would prefer to find, and are often searching for, full-time jobs while they continue working part time. This percentage had fallen to less than 22 percent in 2008 but then increased sharply to more than 28 percent by early 2010. Despite a slow recovery in the past three years, the fraction for these part-timers remains elevated, above 27 percent, with no apparent tendency to decline further.

None of these workers show up as unemployed in the regularly cited statistics and for this reason are often ignored. Yet many of these individuals

11 The youth unemployment rate in Figure 6 hides the differences between two groups of young Canadians. The unemployment rate for those aged 20-24 is currently about 11 percent, while the rate for those aged 15-19 is about 20 percent and has shown no recovery since the depth of the recession in 2009.

Figure 6: Alternative Canadian Unemployment Rates, 2007-2014



Source: Author's calculations (4-quarter moving averages) using quarterly data from Statistics Canada, Labour Force Survey: Tables 282-0085 and 282-0001.

have experienced a significant decline in their income while others have replaced all or part of their lost income by securing one or more part-time jobs. All of them are burdened by their inability to find full-time work.

The dashed line in Figure 7 shows the average duration of an unemployment spell in Canada, highlighting a significant increase in recent years. Until early 2009, the average spell was 15 weeks to 16 weeks, but with the onset of the recession the average increased to more than 21 weeks. It then declined slightly during 2011 and 2012, but has been increasing again since early 2013. For those individuals who are lucky enough to find new jobs and whose employment-insurance benefits last sufficiently long, the burden of the unemployment period may not be considerable, although the effects of the associated uncertainty while searching for a new job should not be underestimated. But for the large fraction of Canadian workers who either do not qualify for employment insurance (Mendelsohn and Medow 2010) or whose benefits expire before they get re-employed, any time without a job can be a serious problem and longer periods are clearly an even greater worry.

The lengthening of the average unemployment spell evident in Figure 7 has a statistical counterpart in the growing incidence of long-term

unemployment, as shown in Figure 8. In the years immediately prior to the recession, about 13 percent of unemployed Canadians had been unemployed for between 27 weeks and one year, while about 4 percent had been unemployed for longer than a year. Both fractions increased during the recession and have so far remained at their elevated levels. By early 2014, 20 percent of unemployed Canadians had been without work for between 27 weeks and one year, while 7 percent had been unemployed for more than a year.

The OECD (2013) estimates that only about one-half of currently "displaced" Canadian workers are re-employed within one year of losing their jobs, and only about two-thirds are re-employed after two years. The implication is that roughly one-third of displaced Canadians must wait longer than two years to find re-employment. The immediate economic as well as social costs to self and family, combined with the longer-term costs associated with the degradation of human capital and employability, make long-term unemployment a first-order economic and social problem.

What Should Policymakers Do?

This *Commentary* has made several main points. First, the Bank of Canada is currently engaged in very expansionary monetary policy and there are good reasons why further expansions would either be undesirable or of limited efficacy. Second, there is some room for Canada's fiscal authorities to provide more stimulus to aggregate demand, but given the considerable practical limitations with discretionary fiscal policy, combined with Canada's future fiscal challenges, it is probably best to return budgets to balance sooner rather than later. Third, the nature of the current deleveraging process across the developed economies, combined with the general lack of confidence in the global economy, suggests that we should not expect timely recoveries in the major components of Canadian private demand, especially investment and exports.

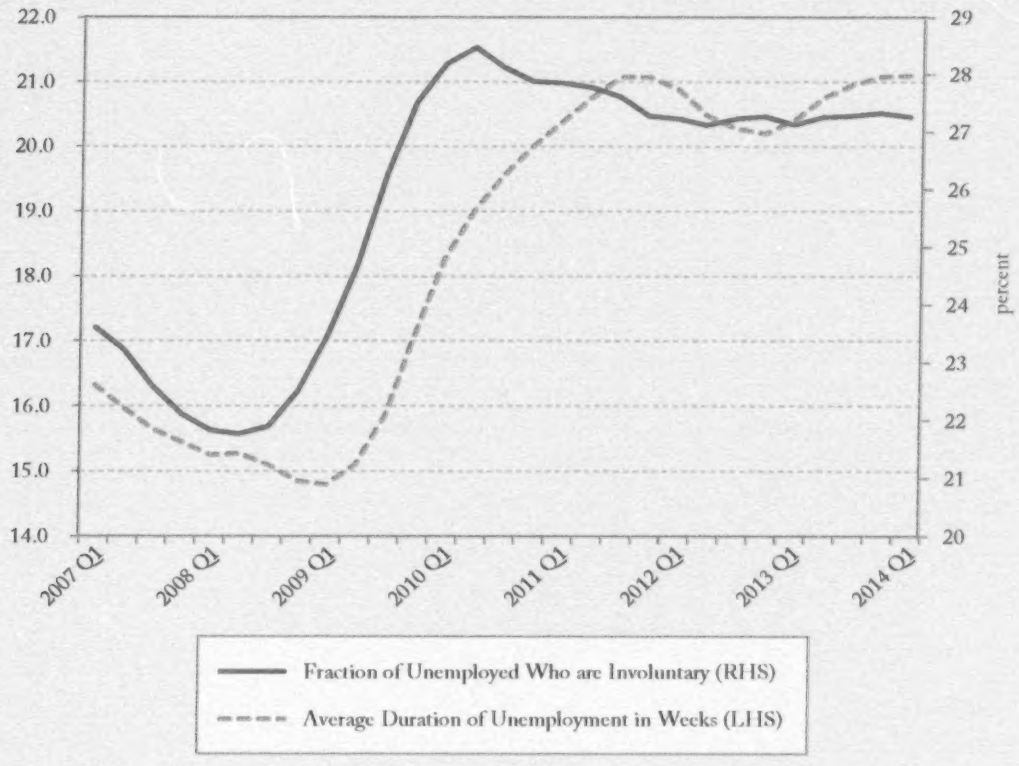
These three points suggest a fourth: that Canadian policymakers should accept the likelihood of continued slow economic growth for the next few years. If the most recent IMF forecasts are to be taken seriously, growth will likely increase from the past two years, but a return to pre-recession annual growth rates – something closer to 3 percent in Canada – should not be expected soon. A final point is that such a slow-growth recovery contains important challenges; slow growth diminishes the labour market's ability to absorb the increasing number of willing participants. The greatest burden of slow growth falls on the unemployed and underemployed.

The central policy implication is that federal and provincial policymakers need to focus less on the standard tools of conventional macroeconomic stabilization – monetary and fiscal policies – and instead focus their attentions on labour-market policies that, if designed well, could alleviate the burden currently being experienced by the unemployed and underemployed.[12]

In his maiden speech as Governor of the Bank of Canada, Stephen Poloz quite rightly emphasized the need for "stability and patience" (Poloz 2013). That is, stability to shore up the weak level of confidence and patience to allow the

12 An additional conclusion, also supported by the arguments presented here, is that policymakers should pursue longer-run structural reforms aimed at increasing the growth rate of output from the supply side. Examples would include enhanced competition, further trade liberalization, greater emphasis on innovation and increased acquisition of human capital. Such structural policy reforms, which typically bear fruit only over the longer term, are almost always a good idea. They are also well beyond the scope of this *Commentary*.

Figure 7: Involuntary Part-Time Workers and Unemployment Duration, 2007-2014



Source: Author's calculations (4-quarter moving averages) using data from Statistics Canada, Labour Force Survey, Tables 282-0013 and 282-0047.

global deleveraging process to run its course and (eventually) provide the much-needed stimulus to Canadian aggregate demand. But being patient should not mean doing nothing. Instead, it should mean placing less emphasis on monetary and fiscal policies that reside with the federal government and more emphasis on labour-market policies that are (often) within the realm of the provincial governments.

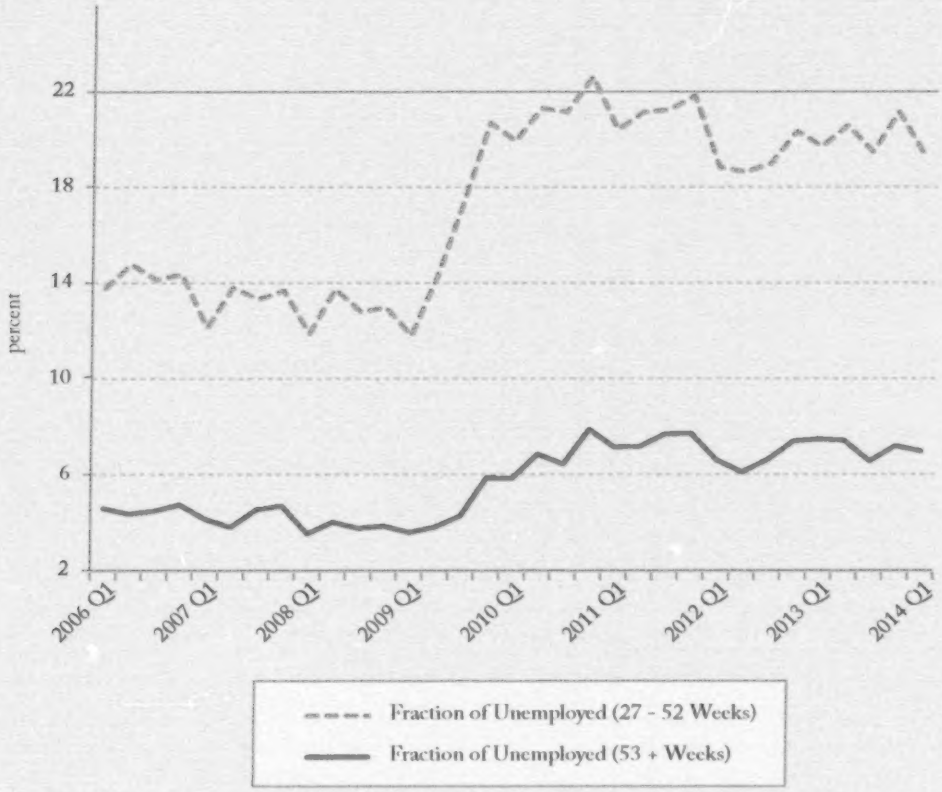
Some Possible Policy Improvements

The OECD (2013) has suggested that Canada's policymakers should design new policies providing "targeted assistance" to those bearing the greatest burden of our slow-growth recovery. Given the data presented in the previous section, three types of policy initiatives come to mind:

- increasing income support to unemployed workers;
- improving labour-market mobility; and
- enhancing training and skills acquisition.

These policy actions would take effect over different time horizons – offering assistance immediately, in the medium term and over the longer term, respectively. In this sense, they constitute a coherent package of labour-market proposals.

Figure 8: Long-Term Unemployment in Canada, 2006-2014



Source: Author's calculations using data from Statistics Canada, Labour Force Survey, Table 282-0047.

A. Increase Support to the Unemployed

Given the still-elevated levels of unemployment, and especially high youth unemployment and the high incidence of long-term unemployment, there is a compelling case for improving workers' access to income support. Any improvements here would immediately address the considerable burden felt by these individuals. It might be best, however, to design a new program rather than to increase the generosity of the existing Employment Insurance (EI) program. As Mendelsohn and Medow (2010) argue, policy adjustments and more gradual changes in the labour market have produced an EI program that is no longer well suited to our needs, as reflected by the substantial decline in the fraction of unemployed workers now eligible to receive benefits. Increases in the generosity of EI benefits

would not address some of the program's more fundamental weaknesses.[13]

A more promising alternative, first suggested by Davis (2012), is to introduce a program of temporary unemployment assistance (TUA) to provide unemployed workers with financial support that is repaid after a few years, possibly contingent on their income. Such a program would essentially be a government-provided loan to needy unemployed individuals and, if designed appropriately, could have a negligible fiscal cost over the repayment horizon.

B. Improve Labour Mobility

As is often the case in a country with disparate regions and economic sectors, some of Canada's unemployment is structural in nature, caused by mismatches between labour demand and supply (Bergevin 2013). An effective way to reduce some of this structural unemployment is to improve labour mobility, both across regions and across sectors. Policies directed to these goals will be unlikely to generate immediate benefits but will produce gains over a period of several months or a few years.

The current EI program contains many obstacles to labour mobility (see, for example, Busby, Laurin and Gray 2009, and Mendelsohn and Medow 2010). In particular, the program's "regionally extended benefits," whereby unemployed workers collect benefits for longer (and qualify after fewer hours of employment) in areas of higher unemployment provides a clear disincentive for unemployed individuals in a high unemployment region to move to one in which re-employment prospects might be more promising. (Although the federal government recently made EI changes to encourage more labour-market mobility, it did not alter this fundamental aspect of the program.)

Reducing seasonal workers' EI access would also improve labour-mobility incentives, although this is obviously a highly charged political issue. However, if the government were to simultaneously introduce some form of temporary unemployment assistance, such EI restrictions might become more feasible politically.

Given Canada's federal structure, it is not surprising that an important obstacle to national labour mobility comes from differences in provincial regulations regarding certifications for professions and skilled trades. Knox (2010) has argued that, despite some regulatory changes enacted in 2009, these regulations could be further standardized across provinces. Similarly, the OECD (2013) argues that such measures would improve Canada's labour mobility and help reduce unemployment. Such changes clearly lie within the jurisdiction of the provinces, although the importance of the issue suggests a role for the federal government in bringing the provinces together and facilitating a coherent discussion.

C. Enhance Labour-Market Training

A third measure is to improve labour-market training so that workers displaced from one sector or region can more easily make the transition to a new position, reducing the duration of labour-market mismatches. Policy improvements in this area are likely to generate a payoff only over the longer term, but should nonetheless be pursued.

13 Mendelsohn and Medow (2010) note that the ratio of EI beneficiaries to unemployed fell from about 76 percent in 1990/91 to about 46 percent today, reflecting both a tightening of the eligibility conditions and a growing importance of "non-standard" employment. There are also considerable regional variations in this ratio, reflecting differences in the prevalence of seasonal work and in regional unemployment rates, which affect the eligibility conditions.

Labour-market training is wholly within the constitutional jurisdiction of the provinces, and Ottawa currently has labour-market agreements with each of them whereby they receive federal funds to operate their own training programs. After considerable initial provincial opposition, the federal government recently created the Canada Job Grant in an attempt to improve the quantity and quality of labour-market training. It is obviously too early to determine whether this new program, which is to replace the existing labour-market agreements that expire later this year, will achieve its stated objectives. But given the jurisdictional division of powers and the importance of training to Canada's labour-market success, this is another domain in which there is a clear role for the federal government to provide collegial leadership.

Finally, Canada's Temporary Foreign Worker (TFW) program has garnered much recent attention and is worth viewing through the lens of policy efforts to improve labour-market training. To the extent that Canadian firms have ready access to a supply of trained foreign workers, there is a clear disincentive to provide Canadian workers with the skills necessary for successful employment. The federal government recently introduced several changes to the program designed to increase the difficulty of hiring foreign workers rather than domestic ones, especially unskilled workers. Time will tell if these changes strike the right balance between the desire to return Canadians to the workforce and the need to fill temporary holes in that same workforce with appropriate foreign workers.

Despite the recent changes, however, there are growing concerns surrounding the past decade's dramatic expansion of the TFW program and the fact that Canadian firms in many sectors appear to be relying permanently on a steady rotation of temporary workers (Foster 2012). As a result, the federal government should carefully examine the relationship between the TFW program and the incentives for firms to undertake training of domestic workers.

CONCLUSIONS

This *Commentary* has intentionally ignored the many important structural factors that play a central role in determining the economy's long-run rate of growth, and how they could potentially be modified through policy. Examples include the promotion of research and development, further trade liberalization, regulatory reform, public infrastructure renewal, and the improved acquisition of human capital. Any complete study of policy options for improving Canadians' long-run material living standards cannot avoid an examination of these and other structural issues.

Despite the importance of such longer-run policy initiatives, this *Commentary*'s focus has been on addressing the shorter-run cyclical challenges that Canada has faced since the onset of the global financial crisis and that it will continue to face for the next few years. The emphasis has, therefore, been on exploring the likely pace of economic recovery and the associated role for policy. The main conclusions can be summarized as follows:

- Canadian monetary policy has little ability to further stimulate growth over the next few years. Further cuts in the policy interest rate are unlikely to stimulate aggregate demand, and ongoing problems associated with very low interest rates cannot be ignored.
- Canadian fiscal authorities have some room to manoeuvre, but both the limitations of discretionary fiscal policy and longer-term fiscal challenges suggest that Canadian fiscal policy will not add to growth in the next few years.
- Given the slow pace of the ongoing global recovery, based as it is on a lack of confidence and a widespread need for deleveraging, a significant rebound in Canadian private demand, especially investment and exports, is unlikely in the near future.

- Canadian policymakers should, therefore, accept the continuation of Canada's slow-growth recovery as a real possibility for the next few years. Their focus should be on addressing the burden of this slow growth, which falls mostly on unemployed and underemployed Canadians.
- To address this slow-growth burden, Canadian policymakers should focus on approaches that improve income support for the unemployed, increase mobility in labour markets and improve incentives for labour-market training.

REFERENCES

Bank of Canada. 2009. *Monetary Policy Report*. April (especially pages 33-35).

———. 2012. *Financial System Review*. June (especially pages 17-26).

———. 2013a. *Monetary Policy Report*. April (especially Box 4 on page 29).

———. 2013b. *Monetary Policy Report*. July (especially pages 21-23).

———. 2014a. *Business Outlook Survey*. April, page 3.

———. 2014b. *Monetary Policy Report*. April, page 20.

Bergevin, P. 2013. "Who Is Still Standing In Line? Addressing a Mismatch of Skills and Jobs in the Canadian Labour Market." E-Brief 156. Toronto: C.D. Howe Institute. March 6.

Bernanke, B. 2012. "Recent Developments in the Labor Market." Remarks to the National Association of Business Economists, Arlington, Virginia, March 26.

Blanchard, O., G. Dell'Ariccia and P. Mauro. 2010. "Rethinking Macroeconomic Policy."International Monetary Fund, *Staff Position Note*. January.

Blanchard, O., and D. Leigh. 2013. "Growth Forecast Errors and Fiscal Multipliers." International Monetary Fund, *IMF Working Paper* WP/13/1. January.

Blinder, A. 1988. "The Challenge of High Unemployment."*American Economic Review* 78.

Boivin, J., T. Lane, and C. Meh. 2010. "Should Monetary Policy Be used to Counteract Financial Imbalances?" *Bank of Canada Review*, Summer, pp. 23-36.

Busby, C., A. Laurin, and D. Gray. 2009. "Back to Basics: Restoring Equity and Efficiency in the EI Program," E-Brief 84, Toronto: C.D. Howe Institute. August 6.

Canada. 2009. "Canada's Economic Action Plan: Budget 2009." Ottawa, January 27.

Carney, M. 2013. "Canada Works." Speech delivered to the Board of Trade of Metropolitan Montreal. May 21.

Dao, M., and P. Loungani. 2010. "The Human Cost of Recessions: Assessing It, Reducing It." International Monetary Fund, *IMF Staff Position Note*. SPN/10/17. November.

Davis, M. 2012. "Workers Left Outside the EI Umbrella: Explanations and a Simple Solution." Mowat Center for Policy Innovation.

Fisher, R. 2013. "The Status of the U.S. Economy and a Perspective on 'The Modern Monetarism.'" Speech delivered to the C.D. Howe Institute's Directors' Dinner. June 4.

Foster, J. 2012. "Making Temporary Permanent: The Silent Transformation of the Temporary Foreign Worker Program." *Just Labour: A Canadian Journal of Work and Society*. 19: 22-46. Autumn.

Freedman, C., M. Kumhof, D. Laxton, and J. Lee. 2009. "The Case for Global Fiscal Stimulus." International Monetary Fund, *IMF Staff Position Note*, SPN/09/03.G-20. 2008.

"Declaration: Summit on Financial Markets and the World Economy." Available at http://www.canadainternational.gc.ca/g20/summitsommet/g20/declaration_111508.aspx.G-20. 2010.

"The G-20 Toronto Summit Declaration." Available at http://www.canadainternational.gc.ca/g20/summit-sommet/2010/toronto-declaration-toronto.aspx?lang=eng.

Galbraith, J.K. 1993. *A Short History of Financial Euphoria*. Viking Press.

Gilmore, J., and S. LaRochelle- Côté. 2011. "Inside the Labour-Market Downturn." Statistics Canada. February.

International Monetary Fund. 2014a. *World Economic Outlook: Recovery Strengthens, Remains Uneven*. April (see Table 1.1).

———. 2014b. *Canada: 2013 Article IV Consultation*. February.

———. 2014c. *World Economic Outlook: Recovery Strengthens, Remains Uneven*. April (Table A8 on p.192).

Johnson, S., and J. Kwak. 2010. *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*. Vintage Books.

Kindleberger, C., and R. Aliber. 2005. *Manias, Panics, and Crashes: A History of Financial Crises* (Fifth Edition). John Wiley and Sons.

Kneebone, R., and J. Chung. 2004. "Where Did the Debt Come From?" in C. Ragan and W. Watson (eds.), *Is the Debt War Over? Dispatches From Canada's Fiscal Frontline*. Institute for Research on Public Policy.

Knox, R. 2010. "Who Can Work Where: Reducing Barriers to Labour Mobility in Canada." Backgrounder 131. Toronto: C. D. Howe Institute. June.

Kozicki, S., E. Santor, and L. Suchanek. 2011. "Unconventional Monetary Policy: The International Experience with Central Bank Asset Purchases." *Bank of Canada Review*, Spring, p. 13-25.

Lazear, E., and J. Spletzer. 2012. "The United States Labor Market: Status Quo or A New Normal?" Unpublished manuscript. July 22.

Lucas, R. 1987. *Models of Business Cycles*. Basil Blackwell (especially chapter 3).

Macklem, T. 2013a. "Regearing Our Economic Growth." Speech delivered to Queen's University. January 10.

———. 2013b. "Global Growth and the Prospects for Canada's Exports." Speech delivered to the Economic Club of Canada, Toronto. October 1.

Madani, D. 2012. "Bank of Canada Close to Dropping Hawkish Bias." Capital Economics, *Bank of Canada Watch*. August 28.

Masson, P. 2013. *The Dangers of an Extended Period of Low Interest Rates: Why the Bank of Canada Should Start Raising Them Now*. Commentary 381. Toronto: C.D. Howe Institute. May.

Mendelsohn, M., and J. Medow. 2010. "Help Wanted: How Well Did the EI Program Respond During Recent Recessions?" Mowat Centre for Policy Innovation. September.

OECD. 2013. *OECD Employment Outlook 2013*, Organization for Economic Cooperation and Development. July.

Poloz, S. 2013. "Reconstruction: Rebuilding Business Confidence in Canada." Speech delivered to the Oakville Chamber of Commerce. June 19.

———. 2014. "Redefining the Limits to Growth." Speech delivered to the Halifax Chamber of Commerce. March 18.

Ragan, C. 2005. "The Exchange Rate and Canadian Inflation Targeting." *Bank of Canada Review*, Autumn 2005. pp.41-50.

———. 2010. "A Federal Budget Designed for the Times: The Economic Action Plan of 2009," in C. Beach, B. Dahlby and P. Hobson (eds.), *The 2009 Federal Budget: Challenge, Response, and Retrospect*. John Deutsch Institute for the Study of Economic Policy, Queen's University, pp. 35-56.

———. 2012. "Canada's Looming Fiscal Squeeze." Macdonald-Laurier Institute. March.

Reinhart C., and V. Reinhart. 2010. "After the Fall." Paper presented at the Federal Reserve Bank of Kansas City annual conference at Jackson Hole, Wyoming. August.

Reinhart, C., and K. Rogoff. 2008. "Is the U.S. Subprime Crisis So Different? An International Historical Comparison." *American Economic Review: Papers and Proceedings* 98: 339-44.

———. 2009. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton University Press.

Robson, W. 2010. "The Glacier Grinds Closer: How Demographics Will Change Canada's Fiscal Landscape." E-Brief 106. Toronto: C.D. Howe Institute. September.

Spilimbergo, A., S. Symansky, and M. Schindler. 2009. "Fiscal Multipliers." International Monetary Fund, *IMF Staff Position Note*, SPN/09/11.

Stanford, J. 2012. "Canada's Incomplete, Mediocre Recovery." Canadian Centre for Policy Alternatives. *Technical Paper*. January.

TD Economics. 2013. "Canadian Households More Indebted Than U.S. Households, But Only After the Recent U.S. Deleveraging." *Observation*. July 16.

———. 2014. "Global Outlook: Slow Start Does Not Preclude Stronger Finish." *TD Economics Quarterly Economic Forecast*. June 23.

Temin, P. 1989. *Lessons from the Great Depression*. MIT Press.

White, W. 2009. "Should Monetary Policy 'Lean or Clean'?" Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute Working Paper No. 34. August.

White, W. 2012. "Ultra Easy Monetary Policy and the Law of Unintended Consequences." Federal Reserve Bank of Dallas Working Paper No. 126. September.

NOTES:

NOTES:

Recent C.D. Howe Institute Publications

July 2014	Scarth, William. *User Discretion Advised: Fiscal Consolidation and the Recovery.* C.D. Howe Institute Commentary 412.
July 2014	Dachis, Benjamin, William B.P. Robson, and Nicholas Chesterley. "Capital Needed: Canada Needs More Robust Business Investment." C.D. Howe Institute E-Brief.
July 2014	Steele, Jana R., Angela Mazerolle, and Mel Bartlett. *Target-Benefit Plans in Canada – An Innovation Worth Expanding.* C.D. Howe Institute Commentary 411.
June 2014	Cross, Philip. "The Public Purse versus Private Wallets: Comparing Provincial Approaches to Investing in Economic Growth." C.D. Howe Institute E-Brief.
June 2014	Richards, John. "What Policies Work? Addressing the Concerns Raised by Canada's PISA Results." C.D. Howe Institute E-Brief.
June 2014	Richards, John. "Warning Signs for Canadian Educators: The Bad News in Canada's PISA Results." C.D. Howe Institute E-Brief.
June 2014	Robson, William B.P., and Alexandre Laurin. "Outliving Our Savings: Registered Retirement Income Funds Rules Need a Big Update." C.D. Howe Institute E-Brief.
May 2014	Forget, Claude E. *Le Mystère des Médecins Québecois « Évanouis »: Comment Améliorer L'accès Aux Soins.* Commentaire 410.
May 2014	Forget, Claude E. *The Case of the Vanishing Québec Physicians: How to Improve Access to Care.* C.D. Howe Institute Commentary 410.
May 2014	Busby, Colin, and Miles Corak. "Don't Forget the Kids: How Immigration Policy Can Help Immigrants' children." C.D. Howe Institute E-Brief.
May 2014	Li, Nicholas. *Sticker Shock: The Causes of the Canada-US Price Differential.* C.D. Howe Institute Commentary 409.
April 2014	Richards, John. *Are We Making Progress? New Evidence on Aboriginal Education Outcomes in Provincial and Reserve Schools.* C.D. Howe Institute Commentary 408.
April 2014	Gross, Dominique M. *Temporary Foreign Workers in Canada: Are They Really Filling Labour Shortages?* C.D. Howe Institute Commentary 407.

Support the Institute

For more information on supporting the C.D. Howe Institute's vital policy work, through charitable giving or membership, please go to www.cdhowe.org or call 416-865-1904. Learn more about the Institute's activities and how to make a donation at the same time. You will receive a tax receipt for your gift.

A Reputation for Independent, Nonpartisan Research

The C.D. Howe Institute's reputation for independent, reasoned and relevant public policy research of the highest quality is its chief asset, and underpins the credibility and effectiveness of its work. Independence and nonpartisanship are core Institute values that inform its approach to research, guide the actions of its professional staff and limit the types of financial contributions that the Institute will accept.

For our full Independence and Nonpartisanship Policy go to www.cdhowe.org.

C.D. HOWE
INSTITUTE

67 Yonge Street, Suite 300,
Toronto, Ontario
M5E 1J8

Canadian Publication Mail Sales
Product Agreement #40008848